

Internal Revenue Service

memorandum

CC:TL-N-7782-88

Br2:JMOrenstein

date: **AUG 31 1988**

to: District Counsel, Oklahoma City CC:OKL
Attn: Gary Bloom

from: Director, Tax Litigation Division CC:TL

subject: Claims for refund based upon decision entered in Hendrickson v. Commissioner, T.C. Memo. 1987-566

By memorandum dated June 22, 1988, you requested technical advice due to the abundance of claims pending in the Austin Service Center as a result of the decision entered in the above-referenced case.

ISSUE

Whether income derived from participation as a coowner of a mineral lease is includible in computing net earnings from self-employment for purposes of the self-employment tax pursuant to I.R.C. § 1401.

CONCLUSION

Income derived from participation as a coowner of a mineral lease is includible in computing net earnings from self-employment for purposes of the self-employment tax. Moreover, where the government can argue that the investment group constituted a partnership, the government should assert that the entity is a partnership engaged in a trade or business such that the amounts distributed to the individual partners would be subject to the self-employment tax. Pending refund claims should be disallowed.

DISCUSSION

The Tax Court in Hendrickson v. Commissioner, T.C. Memo. 1987-566, held that the taxpayer was not carrying on a trade or business as the owner of a 21.875 percent working interest in each of three separate oil and gas properties. The Service had argued that while the taxpayer was not engaged in a trade or business in his individual capacity, he was engaged in a trade or business through his agency relationship with Continental, the operator. The taxpayer had delegated his authority in the venture to Continental. The Tax Court determined that such delegation of authority to Continental did not create an agency relationship since the taxpayer could not control the actions of Continental on

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his own. Rather, as a holder of a minority interest, the taxpayer could only control Continental in conjunction with other interest holders.

In a recent case, Cokes v. Commissioner, 91 T.C. No. 19 (Aug. 15, 1988), the Tax Court held that the taxpayer was subject to the self-employment tax on the net earnings from her 42-percent working interest in certain property. While her interest was nearly double that of Hendrickson's interest she, nevertheless, was a minority interest holder. The factor which distinguished Cokes from the Hendrickson case was that the Service argued and the Tax Court agreed, consistent with Rev. Rul. 58-166, 1958-1 C.B. 324, that the interest holders in Cokes constituted a partnership for tax purposes. Section 1402(a) provides that "net earnings from self-employment" include one's distributive share of income from any trade or business carried on by a partnership. In Hendrickson, the Service did not argue that the taxpayer was a member of a partnership.

A proposed Action on Decision has been prepared in the Hendrickson case and is attached for your information. The AOD discusses the importance of making the partnership argument in addition to the agency argument where the existence of a partnership can be established. We continue to believe, however, that even where a partnership does not exist a taxpayer is engaged in a trade or business and is subject to self-employment tax even if a minority interest is involved. For that reason, we recommend that the Service continue to litigate these cases and that any pending claims for refund be disallowed.

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Attachments:

Hendrickson AOD
Cokes v. Commissioner, slip opinion

CC: Pat Putzi, Tax Litigation Petroleum ISP Coordinator